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12 UNITED STATES DISTRICT COURT

13 CENTRAL DISTRICT OF CALIFORNIA

14
15 IN RE NEW CENTURY) Consolid. Case No. 2:07-CV-00931-DDP
16) (FMOx)

17) CLASS ACTION

18) **DEFENDANT KPMG LLP'S NOTICE**
19) **OF MOTION AND MOTION TO**
20) **DISMISS PLAINTIFFS' SECOND**
21) **AMENDED CONSOLIDATED**
22) **CLASS ACTION COMPLAINT;**
23) **MEMORANDUM OF POINTS AND**
24) **AUTHORITIES IN SUPPORT**
25) **THEREOF**

26) [Request for Judicial Notice and
27) Declaration of Robert B. Martin III Filed
28) Concurrently Herewith]

Date: September 8, 2008, 10:00 a.m.
Before: Honorable Dean D. Pregerson

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1 This motion is made following the conference of counsel pursuant to C.D.
2 Local Rule 7-3, which took place on May 27, 2008.

MEMORANDUM OF POINTS AND AUTHORITIES**INTRODUCTION**

This case arises out of the sudden failure of New Century Financial Corporation (“New Century” or “the Company”), which was one of the nation’s largest mortgage finance companies. The first complaint in this action, which did not assert any claims against defendant KPMG LLP (“KPMG”), was filed immediately following New Century’s initial disclosure of bad news in early February 2007. That disclosure was quickly followed by a cascade of other adverse disclosures about New Century’s deteriorating prospects in February and March 2007, all of which occurred against the backdrop of the developing collapse of the entire subprime mortgage industry. New Century filed for bankruptcy in April 2007.

The current complaint asserts two claims against KPMG: a claim for violation of Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (Count Three); and a claim for violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder (Count Seven). The claim under Section 11 is a reprise of a claim the Court dismissed once before. The claim against KPMG under Section 10(b) is entirely new and, as developed below, is improperly based upon plaintiffs’ selective reliance upon passages in a bankruptcy examiner’s report that was unsealed in the New Century bankruptcy on March 27, 2008. Both claims should be dismissed for the following reasons.

First, plaintiffs have failed to comply with this Court’s January 31, 2008 Order dismissing plaintiffs’ Consolidated Class Action Complaint. The complaint is neither clear nor concise and does not articulate in an orderly way the basis for the claims asserted.

Second, despite its length, the complaint still includes no facts sufficient to show loss causation with respect to any alleged misrepresentation by KPMG. The only statements at issue here are KPMG’s audit opinion on New Century’s 2005

1 financial statements and its related opinion on New Century's 2005 internal controls.
 2 None of the disclosures made in February and March 2007 that plaintiffs rely upon
 3 corrected any alleged error in the Company's 2005 financial statements or alleged
 4 deficiencies in its 2005 internal controls. And none of the disclosures addressed
 5 KPMG's 2005 work or its 2005 opinions. Under these circumstances, plaintiffs have
 6 not, and cannot, adequately allege loss causation as to KPMG. To the contrary, the
 7 complaint demonstrates on its face the absence of loss causation.

8 Finally, plaintiffs' Section 10(b) claim should be dismissed for the independent
 9 reason that plaintiffs have failed to allege adequately facts that support a strong
 10 inference of scienter. Plaintiffs' selective incorporation of assertions of a non-party
 11 examiner—who was appointed to identify potential claims for the benefit of New
 12 Century's creditors—do not suffice to create a strong inference of scienter,
 13 particularly where, as here, the examiner has found no fraud, recklessness, or even
 14 grossly negligent conduct.¹

15 **BACKGROUND**

16 Plaintiffs' claims against KPMG arise out of two audit opinions by KPMG
 17 included in New Century's 2005 fiscal year-end Form 10-K. (Compl. ¶ 258.)
 18 KPMG's 2005 audit opinion stated that KPMG had audited the "consolidated balance
 19 sheets of New Century Financial Corporation and subsidiaries as of December 31,
 20 2005 and 2004, and the related consolidated statements of income, comprehensive
 21 income, changes in stockholders' equity, and cash flows for each of the years in the
 22 three-year period ended December 31, 2005." New Century Fin. Corp. FYE 2005

23
 24
 25 ¹ Moreover, plaintiffs' selective reliance on the examiner's assertions without
 26 performing any independent investigation is improper under Federal Rules of Civil
 27 Procedure 11 and 12(f). KPMG has filed a separate motion to strike plaintiffs'
 28 allegations that merely recite the examiner's assertions. If that motion is granted, the
 Section 10(b) claim should be dismissed without the need for any additional analysis.

1 Form 10-K (Mar. 16, 2006), Ex. C at 167.)² KPMG’s opinion stressed that the
 2 “consolidated financial statements are the responsibility of the Company’s
 3 management,” and that KPMG’s responsibility as an auditor was “to express an
 4 opinion on [the] consolidated financial statements based on [its] audits.” (*Id.*) Based
 5 on its audit, KPMG opined that, “[i]n our opinion, the consolidated financial
 6 statements referred to above present fairly, in all material respects, the financial
 7 position of New Century Financial Corporation and subsidiaries as of December 31,
 8 2005 and 2004, and the results of their operations and their cash flows for each of the
 9 years in the three-year period ended December 31, 2005, in conformity with U.S.
 10 generally accepted accounting principles.” (*Id.*)

11 KPMG also issued a companion internal controls opinion stating that: (i)
 12 KPMG had audited management’s assessment “that New Century Financial
 13 Corporation and subsidiaries maintained effective internal control over financial
 14 reporting as of December 31, 2005 . . .”; (ii) “[t]he Company’s management is
 15 responsible for maintaining effective internal control over financial reporting . . .”;
 16 and (iii) in KPMG’s opinion, “management’s assessment that New Century Financial
 17 Corporation and subsidiaries maintained effective internal control over financial
 18 reporting as of December 31, 2005, is fairly stated, in all material respects . . .” (*Id.*
 19 at 165.) KPMG’s 2005 opinion also stated that “projections of any evaluation of
 20 effectiveness to future periods are subject to the risk that controls may become
 21 inadequate because of changes in conditions, or that the degree of compliance with the
 22 policies or procedures may deteriorate.” (*Id.*)³

23
 24 ² Exhibits relied upon by KPMG in this motion are included with the Request for
 Judicial Notice filed concurrently herewith and are cited as “Ex. ____.”

25 ³ Although plaintiffs’ complaint also includes a number of allegations regarding New
 26 Century’s quarterly Form 10-Q filings in 2006, those quarterly financial statements
 27 were not audited by KPMG, KPMG did not issue any opinions regarding those
 28 quarterly statements, and plaintiffs do not seek to hold KPMG liable for any alleged
 misstatements contained in those quarterly statements.

1 Plaintiffs' Section 11 claim (Count Three) is brought on behalf of purchasers of
 2 Series B Preferred Stock that was sold pursuant to a Registration Statement that
 3 incorporated New Century's 2005 Form 10-K and, thus, KPMG's two 2005 audit
 4 opinions. (Compl. ¶ 258.) Plaintiffs' Section 10(b) claim (Count Seven) is brought
 5 on behalf of all purchasers of New Century stock between March 16, 2006, the date of
 6 the filing of New Century's 2005 Form 10-K, and March 13, 2007. Plaintiffs allege
 7 that purchasers of New Century's securities suffered losses when the price of New
 8 Century's securities declined as a result of a series of disclosures in early 2007. (*Id.*
 9 ¶ 9.) These disclosures began on February 7, 2007, with an announcement that New
 10 Century would have to restate its previously reported *unaudited* financial statements
 11 for the first three quarters of 2006, and ended on March 13, 2007, with an
 12 announcement that the New York Stock Exchange had determined that the
 13 Company's securities were "no longer suitable for continued listing on the NYSE and
 14 will be suspended immediately." (*Id.* ¶¶ 474, 476.) The numerous disclosures
 15 between February 7 and March 13, which are detailed at length in the complaint,
 16 constitute a series of increasingly dire announcements of a financial and business
 17 crisis at New Century that affected its ability to operate, including that the Company's
 18 lenders were discontinuing all financing and that the Company, whose business was
 19 mortgage lending, had decided to cease accepting mortgage loan applications. (*See id.*
 20 ¶¶ 457–82.) As a result of these developments, New Century filed for bankruptcy in
 21 April 2007. (*Id.* ¶ 2.)

22 For purposes of their claims against KPMG, plaintiffs focus on two disclosures:
 23 the first adverse disclosure on February 7, and a disclosure on March 2. On February
 24 7, New Century admitted the need to restate its previously reported *unaudited*
 25 financial statements for the first three quarters of 2006.⁴ (*Id.* ¶ 457.) The Company
 26

27 ⁴ In particular, the Company stated that, "[d]uring the second and third quarters of
 28 2006," the Company failed to record the expected discount upon disposition of loans

(Footnote continued)

1 further announced that, “[i]n light of the pending restatements, the Company’s
2 previously filed condensed, consolidated financial statements for the quarters ended
3 March 31, June 30 and September 30, 2006 and all earnings-related press releases for
4 those periods should no longer be relied upon,” and also that it “expect[ed] the
5 combined impact of the foregoing to result in a net loss” for the fourth quarter of
6 2006. (*Id.*) Plaintiffs do not allege that KPMG made any statement at all about New
7 Century’s 2006 unaudited reported financial results that are the subject of the
8 February 7 disclosure.

9 On March 2, 2007, New Century filed a notification that it had “determined that
10 it is unable to file its Annual Report on Form 10-K for the year ended December 31,
11 2006” in a timely fashion. (New Century Fin. Corp. Form 12b-25 (Mar. 2, 2007), Ex.
12 D at 320.) It reiterated that New Century would be restating its *unaudited 2006*
13 interim financial statements. It also announced that, in connection with the
14 restatement process, the Audit Committee of the Company’s Board of Directors had
15 “initiated its own independent investigation into the issues giving rise to the
16 Company’s need to restate its 2006 interim financial statements, as well as issues
17 pertaining to the Company’s valuation of residual interests in securitizations in 2006
18 and prior periods.” (*Id.*) The Company further announced that it “currently expects
19 that the modifications to the allowance for loan repurchase losses will result in
20 restated net income for the first three quarters of 2006 that is significantly lower than
21 previously reported in the Company’s 2006 interim financial statements.” (Compl.
22 ¶ 464.) The Company also announced that, “[a]lthough the Company’s mortgage loan

23 _____
24 when estimating its allowance for loan repurchase losses. (Compl. ¶ 72.) The
25 Company also disclosed that its “methodology for estimating the volume of
26 repurchase claims to be included in the repurchase reserve calculation did not properly
27 consider, in each of the first three quarters of 2006, the growing volume of repurchase
28 claims outstanding that resulted from the increased pace of repurchase requests that
occurred in 2006, compounded by the increasing length of time between the whole
loan sales and receipt and processing of the repurchase request.” (*Id.*)

1 origination volume increased in 2006 when compared to 2005, the Company's results
 2 of operations for the quarter and year ended December 31, 2006 will reflect declines
 3 in earnings and profitability when compared to the same periods in 2005," and that
 4 "[t]he Company currently expects that it will report a pretax loss for both the fourth
 5 quarter and the full year ended December 31, 2006." (*Id.*) The Company outlined
 6 five reasons for the "negative trends in results compared to 2005." (*Id.*) The
 7 Company also announced, among other things, various problems with its credit
 8 facilities, including that it had violated or anticipated violating certain loan covenants
 9 and that it was seeking waivers from its lenders. (*Id.*)

10 Neither the February 7 nor March 2 announcement discussed KPMG. New
 11 Century did not disclose, and in fact never has disclosed, any errors in KPMG's 2005
 12 audit work.

13 ARGUMENT

14 **I. THE COMPLAINT SHOULD BE DISMISSED BECAUSE PLAINTIFFS** 15 **HAVE FAILED TO COMPLY WITH THE COURT'S JANUARY 31,** 16 **2008 ORDER AND FRCP 8(A)**

17 Plaintiffs originally filed a 189-page, 403-paragraph Consolidated Class Action
 18 Complaint in this matter. The Court dismissed that complaint under Federal Rule of
 19 Civil Procedure ("FRCP") 8(a) because its "long and at times, meandering set of
 20 allegations" failed to provide facts "to support that the statements are false or
 21 misleading," and because the disorganization of the complaint made it impossible for
 22 the Court to determine whether plaintiffs had stated a claim. (Order Granting Mot. to
 23 Dismiss 6-7, Doc. # 245 (Jan. 31, 2008).) The Court permitted plaintiffs to replead
 24 but admonished that "[f]or each allegedly false or misleading statement, the
 25 Complaint should identify some facts suggesting that the statement is false or
 26 misleading, and preferably in the same or a paragraph following the statement." (*Id.*)
 27 The Court also instructed plaintiffs to attach a chart as an exhibit to their amended
 28 complaint, setting forth for each claim "(i) the alleged false or misleading statements,

1 including the source of the statement in a registration statement where a required
 2 element of the claim; (ii) the supporting factual allegations; and (iii) the ultimate
 3 conclusion.” (*Id.*)

4 Plaintiffs have not complied with the Court’s Order. There is nothing clear or
 5 concise about plaintiffs’ 569-page, 572-paragraph complaint. It is three times longer
 6 than the original, with allegations against KPMG scattered throughout multiple
 7 sections and without any clear or plain statement of why those allegations state a
 8 claim against KPMG. Plaintiffs’ charts, attached to the complaint as Exhibits D and
 9 E, provide no additional clarity. The charts were supposed to enumerate separately
 10 each allegedly false statement and the facts indicating why each statement was false,
 11 but they instead group multiple statements under one heading and obscure rather than
 12 explicate which party actually *made* the allegedly false statement. In fact, with
 13 respect to KPMG, the charts assert without support or explanation that KPMG is
 14 “responsible” for a multitude of statements that KPMG did not actually make.⁵ This

15 _____
 16 ⁵ Specifically, regarding Exhibit D, which purports to summarize misstatements
 17 supporting plaintiffs’ Section 11 claim, plaintiffs contend KPMG is a “Responsible
 18 Defendant” for Statements 1, 4, 5, and 6. Statement 1 actually consists of four
 19 separate statements, none of which was made by KPMG. (Compl. Ex. D at 410–14.)
 20 Statement 4 consists of six different statements, only two of which even refer to the
 21 2005 financial statements audited by KPMG, and the “fact” that allegedly
 22 demonstrates that KPMG’s 2005 audit opinion was false when made was New
 23 Century’s statement that it was “more likely than not” that the 2005 financial
 24 statements were materially overstated. (*Id.* at 419–28.) This vague and equivocal
 25 disclosure is not a “fact” at all. Plaintiffs otherwise indiscriminately incorporate more
 26 than 130 numbered “paragraphs” of the complaint as purported “facts” showing that
 27 one or more (without clearly identifying which ones) of the multiple different
 28 statements that plaintiffs lump together were false. Statement 5 consists of six
 separate statements, again, none of which was made by KPMG. (*Id.*) Statement 6
 contains excerpts of KPMG’s 2005 audit opinions (*id.* at 431–35), but the only
 supporting “factual support” is a cross-reference to paragraphs 204–35 of the
 complaint, 42 pages of disjointed allegations with no detail as to *how* those allegations
 show that KPMG’s audit opinions are actionable under Section 11. Regarding Exhibit
 E, which purports to summarize misstatements as to the Section 10(b) claims,

(Footnote continued)

1 non-compliance justifies dismissal. *See In re Splash Tech. Holdings Sec. Litig.*, 160
 2 F. Supp. 2d 1059, 1073 (N.D. Cal. 2001) (dismissing under Rule 8(a) a securities
 3 complaint that “tips the scales at 124 pages” and has a structure that “renders it
 4 exceedingly difficult to discern precisely which statements are alleged to be
 5 misleading”); *see also United States v. Lockheed-Martin Corp.*, 328 F.3d 374, 378–79
 6 (7th Cir. 2003) (affirming dismissal of 155-page, 400-paragraph complaint and noting
 7 that “Rule 8(a) requires parties to make their pleadings straightforward, so that judges
 8 and adverse parties need not try to fish a gold coin from a bucket of mud . . .”).

9 **II. COUNTS THREE (SECTION 11) AND SEVEN (SECTION 10(B))**
 10 **SHOULD BE DISMISSED AS TO KPMG BECAUSE PLAINTIFFS’**
 11 **COMPLAINT MAKES CLEAR THAT KPMG DID NOT CAUSE**
 12 **PLAINTIFFS TO SUFFER ANY LOSS**

13 Counts Three and Seven allege that KPMG is liable under Section 11 and
 14 Section 10(b), respectively, for damages caused by KPMG’s alleged “untrue
 15 statements of material fact.” (Compl. ¶¶ 320–31, 566–71.) Plaintiffs’ allegations are
 16 plainly insufficient to state a claim, because it is apparent on the face of the complaint
 17 that the alleged drop in stock price from the date of New Century’s first negative
 18 disclosure on February 7, 2007, through the end of the class period on March 13,
 2007, was not caused by any of KPMG’s alleged misrepresentations.

19 Loss causation is an essential element of a Section 10(b) claim. *See* 15 U.S.C.
 20 § 78u-4(b)(4); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 344, 125 S. Ct. 1627, 161
 21 L. Ed. 2d 577 (2005). The Supreme Court has made clear that the only loss
 22 recoverable under the securities laws is one that follows in the wake of, and thus can
 23 be fairly said to have been caused by, a disclosure of the alleged fraud. *Id.* Thus, to

24 _____
 25 plaintiffs attributed Statements 28, 29, and 30 to KPMG even though, once again,
 26 KPMG did not actually make any of the statements. (Compl. Ex. E at 505–10.)
 27 Statement 31, which excerpts KPMG’s 2005 audit opinions, suffers from the same
 28 factual deficiency as Statement 6 in Exhibit D, specifically that plaintiffs offer no facts
 as to *how* KPMG’s audit opinions are actionable under Section 10(b). (*Id.* at 511–20.)

1 establish loss causation, plaintiffs must allege: (i) the existence of a corrective
 2 disclosure, *i.e.*, an announcement containing factual information that discloses
 3 wrongdoing or corrects a misstatement *made by KPMG*; and (ii) a drop in stock price
 4 following this corrective disclosure. *In re Daou Sys., Inc. Sec. Litig.*, 411 F.3d 1006,
 5 1025 (9th Cir. 2005); *see Dura*, 544 U.S. at 344; *In re Hansen Corp. Sec. Litig.*, 527
 6 F. Supp. 2d 1142, 1162 (C.D. Cal. 2007); *In re Leapfrog Enters., Inc. Sec. Litig.*, 527
 7 F. Supp. 2d 1033, 1041 (N.D. Cal. 2007).

8 Loss causation also is required under Section 11. Section 11 expressly provides
 9 a defense—the so-called “negative causation defense”—when the specific alleged
 10 misrepresentation or omission upon which the defendant is sued did not cause the
 11 plaintiffs’ claimed damages; in other words, when there is an absence of loss
 12 causation. *See* 15 U.S.C. § 77k(e). When it is apparent on the face of the complaint
 13 that there is no loss causation, a Section 11 claim should be dismissed. *Cats v.*
 14 *Protection One, Inc.*, 2001 U.S. Dist. LEXIS 25725, at *37–38 (C.D. Cal. June 5,
 15 2001) (dismissing Section 11 claim when the complaint showed on its face that there
 16 was no causal link between plaintiff’s damages and defendant’s alleged
 17 misrepresentations); *In re DNAP Sec. Litig.*, 2000 U.S. Dist. LEXIS 13482, at *8–11
 18 (N.D. Cal. Sept. 14, 2000) (same); *see In re Alamosa Holdings, Inc. Sec. Litig.*, 382 F.
 19 Supp. 2d 832, 865 (N.D. Tex. 2005) (dismissing Section 11 claim for absence of loss
 20 causation); *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 272 F. Supp.
 21 2d 243, 254 (S.D.N.Y. 2003) (same); *see also McCalden v. Cal. Library Ass’n*, 955
 22 F.2d 1214, 1219 (9th Cir. 1990) (dismissal proper where defense appears “on the face
 23 of the pleading”).

24 Plaintiffs allege that they sustained losses when New Century’s stock declined
 25 after a series of corrective disclosures in February and March 2007. (Compl. ¶¶ 538–
 26 40.) However, the only alleged misrepresentations by KPMG are alleged
 27 misrepresentations attributed to KPMG’s 2005 audit opinions. (*Id.* ¶¶ 538–40; Compl.
 28

Ex. D at 410–14, 419–35; Compl. Ex. E at 508–20.) Thus, to state a claim against KPMG, the stock drops from February 7 through March 13, 2007, must have been in response to a disclosure that corrected the alleged misrepresentations in KPMG’s 2005 audit reports. But, the disclosures cited by plaintiffs either: (i) corrected problems with New Century’s *unaudited 2006* financial statements (about which KPMG made no representations whatsoever); or (ii) addressed even more recent 2007 developments impacting New Century’s current operations – again, matters about which KPMG made no representations. (*Id.*) In short, not a single disclosure between February 7 and March 13, 2007, included any information about KPMG’s 2005 audit work. Nor did any disclosure correct any purported misstatements in New Century’s 2005 financial statements or any opinion issued by KPMG.⁶

Plaintiffs specifically point to two disclosures as the basis for alleging loss causation with respect to KPMG: the disclosures on February 7 and March 2, 2007. (*Id.*) According to plaintiffs, the February 7 disclosure “specifically concerned accounting and internal control issues with which KPMG was extensively involved in its 2005 audits and areas in which KPMG specifically violated GAAS and the standards of the PCAOB in connection with its 2005 audits.” (*Id.* at ¶ 539.) But the February 7 announcement said nothing about New Century’s 2005 financial statements and did not disclose any wrongdoing by KPMG, or correct any of KPMG’s

⁶ The first disclosure regarding errors in New Century’s 2005 financial statements generally was not until May 24, 2007, well after the close of the class period and well after plaintiffs, by their own admission (*see* Compl. ¶ 9), suffered their losses. *See In re Leapfrog*, 527 F. Supp. 2d at 1041 (events and disclosures after the end of the class period cannot supply the missing loss causation link). This disclosure cannot form the basis for any claim against KPMG. *In re Daou*, 411 F.3d at 1026–27 (decline in stock price cannot be causally related to fraudulent accounting practices where price dropped before alleged revelation of fraud); *In re Hansen*, 527 F. Supp. 2d at 1162 (explaining that if the improper accounting did not lead to the decrease in stock price, plaintiffs’ reliance on the improper accounting in acquiring the stock would not be sufficiently linked to their damages).

1 2005 audit work. *See In re Hansen*, 527 F. Supp. 2d at 1162 (dismissing securities
2 claim because alleged corrective disclosures did not disclose wrongdoing).

3 In particular, the Company stated on February 7 that: (a) “[d]uring the second
4 and third quarters of 2006 . . . the Company did not include the expected discount
5 upon disposition of loans when estimating its allowance for loan repurchase losses”;
6 and (b) its “methodology for estimating the volume of repurchase claims to be
7 included in the repurchase reserve calculation did not properly consider, in each of the
8 first three quarters of 2006, the growing volume of repurchase claims outstanding that
9 resulted from the increased pace of repurchase requests that occurred in 2006”
10 (Compl. ¶ 72.) As a result, the Company predicted a fourth quarter loss and instructed
11 that its financial statements for the first three quarters of 2006 should no longer be
12 relied upon. (*Id.*) None of these admissions said anything about New Century’s 2005
13 financial statements or internal controls, let alone disclosed any wrongdoing by
14 KPMG. Plaintiffs’ attempt to connect the February 7 disclosure with KPMG’s 2005
15 audit work (*id.* ¶ 539) is simply untenable and plainly inadequate.⁷

16 The March 2 disclosure suffers from similar deficiencies. New Century
17 announced that it would not be able to file its 2006 Form 10-K on a timely basis and
18 reiterated that New Century would be restating its *unaudited 2006* interim financial
19 statements. (*Id.* ¶ 464.) Because those disclosures did not discuss KPMG or its 2005
20 audit work, they cannot be the cause of plaintiffs’ alleged losses. *See, e.g., Weiss v.*
21 *Amkor Tech., Inc.*, 527 F. Supp. 2d 938, 946 (D. Ariz. 2007) (dismissing claims on
22 loss causation grounds where complaint alleged stock price fell in response to a press
23 release that was not a “disclosure correcting the Company’s prior statements”); *In re*
24 *Alamosa*, 382 F. Supp. 2d at 866 (dismissing claim where complaint alleged that stock

25 ⁷ By plaintiffs’ logic, if a company announces a need to restate its financials with
26 respect to one year, its announcement would operate as a corrective disclosure for
27 each prior year in which the same accounting issue was addressed. There is no
28 support for this position.

1 price declined in response to press release that did not disclose errors in challenged
2 registration statement).

3 Plaintiffs' remaining loss causation allegation focuses on two words in a single
4 sentence in New Century's March 2 announcement. (Compl. ¶ 540.) Plaintiffs allege
5 that New Century announced that, in connection with the restatement process, the
6 Audit Committee of the Company's Board of Directors had "*initiated its own*
7 *independent investigation into the issues giving rise to the Company's need to restate*
8 *its 2006 interim financial statements, as well as issues pertaining to the Company's*
9 *valuation of residual interests in securitizations in 2006 and prior periods.*" (*Id.*
10 ¶ 464 (emphasis in original).) Plaintiffs seemingly assert that this passing reference to
11 "prior periods" constituted a corrective disclosure relating to KPMG's 2005 audit
12 work. (*Id.* ¶ 540.) Plaintiffs are wrong.

13 To constitute a corrective disclosure, a company's announcement must contain
14 factual information that corrects a prior misstatement. *E.g., In re Daou*, 411 F.3d at
15 1026–27 (the plaintiffs' economic loss occurred only after "defendants began to reveal
16 figures showing the company's true financial condition" and that any loss suffered
17 before such revelation "cannot be considered causally related to Daou's allegedly
18 fraudulent accounting methods"); *Weiss*, 527 F. Supp. 2d at 945–48; *In re Hansen*,
19 527 F. Supp. 2d at 1162. The March 2 announcement's oblique reference to 2006
20 "and prior periods" does not meet this standard. That the Company announced merely
21 that it was investigating "issues" pertaining to accounting for residual interests in
22 2006 and in other undefined prior periods—an announcement that did not reveal any
23 wrongdoing or disclose any financial reporting error—does not, as a matter of law,
24 constitute a corrective disclosure sufficient to support a finding of loss causation. *In*
25 *re Hansen*, 527 F. Supp. 2d at 1162 (announcement that company had formed special
26 committee to conduct investigation and would not file Form 10-Q on time was not
27 corrective disclosure triggering loss causation); *Weiss*, 527 F. Supp. 2d at 945–48
28

1 (announcement of investigation into stock option practices was not corrective
2 disclosure even though stock price declined 17% the next day; corrective disclosure
3 occurred a month later when company disclosed it would make material adjustments
4 to financial statements); *In re Avista Corp. Sec. Litig.*, 415 F. Supp. 2d 1214, 1220–21
5 (E.D. Wash. 2005) (announcement of government investigation was not corrective
6 disclosure even though stock price dropped because announcement did “not
7 communicate any factual information about Avista Energy to the market”).

8 Ultimately, plaintiffs’ complaint makes clear that New Century’s stock price
9 did not decline between February 7 and March 13, 2007 because of any disclosure of a
10 misstatement in the Company’s 2005 financial statements or any alleged
11 misrepresentations by KPMG regarding those financial statements. Rather, the stock
12 declined because New Century disclosed in 2007 that its 2006 unaudited financial
13 statements for the first three quarters would be restated, it would report a loss for the
14 entire year of 2006, and, most significantly, that it was then facing a current financial
15 crisis that threatened its very existence. For example, on March 2, the Company
16 disclosed that it would report a loss for 2006 and that it was in violation of, or
17 anticipated violating, certain loan covenants related to the credit facilities it relied
18 upon to fund loans; and on March 8, the Company announced, among other things,
19 that it had approximately \$70 million in outstanding margin calls, that it might not be
20 successful in obtaining additional liquidity, and that it had elected to cease accepting
21 loan applications. In other words, the Company announced that it was ceasing its
22 principal business activity. (Compl. ¶ 464, 468–70.)

23 Then, on March 12, the Company announced that, as of March 9, all the
24 Company’s lenders under its short term repurchase agreements and aggregation credit
25 facilities had discontinued financing the Company or had notified the Company of
26 their intent to do so. (*Id.* ¶ 472.) None of these disclosures had anything to do with
27 any alleged misstatement in New Century’s 2005 financial statements (issued a year
28

earlier) or the correction of any alleged misrepresentation by KPMG in connection with those financial statements.

Because it is thus apparent on the face of the complaint that plaintiffs' losses from February 7 to March 13, 2007, were not caused by any misstatements by KPMG, Counts Three and Seven should be dismissed as to KPMG.

III. COUNT SEVEN SHOULD BE DISMISSED BECAUSE IT DOES NOT PLEAD FACTS GIVING RISE TO A STRONG INFERENCE OF SCIENTER

Count Seven also should be dismissed for failure to allege sufficiently the essential element of scienter. Under the Private Securities Litigation Reform Act ("PSLRA"), plaintiffs suing under Section 10(b) must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). In the Ninth Circuit, the PSLRA requires that a plaintiff "plead, in great detail, facts that constitute strong circumstantial evidence of *deliberately reckless or conscious misconduct.*" *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (emphasis added). In particular for Section 10(b) claims against auditors, plaintiffs must prove:

that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.

DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002); *see also In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994).

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, – U.S. –, 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007), the U.S. Supreme Court adopted a demanding standard for establishing what constitutes a "strong" inference of scienter, holding that "[t]o qualify as 'strong' . . . an inference of scienter must be more than merely plausible or reasonable – it must be *cogent and at least as compelling* as any opposing inference of

1 nonfraudulent intent.” 127 S. Ct. at 2504-05 (emphasis added). The Supreme Court
 2 emphasized that a court “must consider the complaint in its entirety,” and must take
 3 into account not only inferences argued by the plaintiff but also “plausible opposing
 4 inferences.” *Id.* at 2509–10. Thus, an inference of scienter “must be more than
 5 merely ‘reasonable’ or ‘permissible’ – it must be . . . strong in light of other
 6 explanations.” *Id.* at 2510.

7 Plaintiffs’ scienter allegations fail to meet these exacting requirements.
 8 Plaintiffs’ entire theory rests on three unsupported and insufficient allegations. (*See*
 9 *Compl.* ¶ 529.) For reasons described more fully below, none of plaintiffs’
 10 allegations, even if assumed true, gives rise to a strong inference that KPMG’s 2005
 11 audit opinions were issued as a result of deliberate recklessness or conscious
 12 misconduct.

13 **A. The Scienter Allegations in the Second Amended Complaint Are**
 14 **Taken Entirely from the Examiner’s Report and Should Not Be**
 15 **Considered by This Court**

16 As a threshold matter, plaintiffs’ scienter allegations are not based on any
 17 investigation by plaintiffs. Instead, the only new allegations in the complaint on
 18 which plaintiffs base their new Section 10(b) claim are allegations about what the
 19 New Century bankruptcy examiner has asserted. Further, plaintiffs have selectively
 20 quoted the examiner’s assertions in a misleading manner, as described more fully
 21 below. This use of non-party assertions without any independent investigation is
 22 improper under FRCP 11. *See, e.g., In re Connetics Corp. Sec. Litig.*, 2008 U.S. Dist.
 23 LEXIS 9634, at *19–23 (N.D. Cal. Jan. 29, 2008) (striking allegations drawn from an
 24 SEC complaint that were not verified by an independent investigation for failure to
 25 satisfy FRCP 11); *Geinko v. Padda*, 2002 U.S. Dist. LEXIS 3316, at *18–22 (N.D. Ill.
 26 Feb. 26, 2002) (dismissing complaint where allegations were taken from an SEC
 27 complaint and other complaints). Moreover, these allegations are not subjected to
 28 adversarial testing and thus are immaterial as a matter of law. *See In re Merrill Lynch*

1 & Co., Inc. *Research Reports Sec. Litig.*, 218 F.R.D. 76, 78 (S.D.N.Y. 2003).

2 KPMG has filed a separate motion to strike plaintiffs' allegations that merely
3 recite selected assertions of the examiner and wholly ignore the most fundamental of
4 the examiner's observations – that KPMG's conduct may support a claim only for
5 *negligence*, or *negligent* misrepresentation. (*See* New Century TRS Holdings, Inc.
6 Report of Bankruptcy Examiner (Feb. 29, 2008), Ex. A at 23.) Because the highly
7 selective assertions quoted by plaintiffs—which are the sole source of the only new
8 allegations in the complaint and comprise the basis for plaintiffs' scienter allegations
9 (*see* Compl. ¶¶ 516-29)—are subject to being stricken and should not be considered,
10 plaintiffs' Section 10(b) claim against KPMG should be dismissed without the need
11 for any further analysis.

12 **B. Plaintiffs Do Not Plead with Particularity Facts Giving Rise to a**
13 **Strong Inference that KPMG Acted with Deliberate Recklessness or**
14 **Conscious Misconduct**

15 The allegations based on the examiner's report are improper, but even if they
16 are considered, they plainly do not give rise to a strong inference of scienter. Most
17 fundamentally, the examiner found only that KPMG may have acted *negligently*, and
18 never suggests that KPMG consciously or with deliberate recklessness defrauded New
19 Century's investors. The examiner's report itself thus fatally undermines any
20 inference of fraudulent intent that could be drawn, demonstrating the absence of any
21 theory of fraud that is "cogent and at least as compelling as any opposing inference of
22 nonfraudulent intent." *See Tellabs*, 127 S. Ct. at 2404–05. And even beyond this
23 overarching defect, plaintiffs' allegations, whether considered singly or collectively,
24 fail to give rise to a strong inference of scienter.

25 **1. Plaintiffs' allegations that KPMG was "unduly willing to**
26 **acquiesce" in New Century's violations of GAAP do not raise a**
27 **strong inference of scienter**

28 Plaintiffs allege that KPMG's desire to preserve its relationship with New
Century led it to be "unduly willing to acquiesce" in New Century's violations of

GAAP. (Compl. ¶ 516.) However, courts have consistently rejected the argument that scienter can be inferred based on allegations that an accounting firm sought to preserve its client relationship. In fact, courts will generally infer the opposite: that an accounting firm would *not* willingly acquiesce in its client's accounting violations, as an accounting firm "will rarely, if ever, have any rational economic incentive to participate in its client's fraud." *Reiger v. Price Waterhouse Coopers, LLP*, 117 F. Supp. 2d 1003, 1007 (S.D. Cal. 2000); *see also In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 518 (S.D. Ohio 2000) ("The majority of authority have held that a desire to maintain the fees flowing from a client relationship is not a sufficient basis on which to infer scienter.").

Plaintiffs' most belabored example of KPMG's alleged "acquiescence" and "disregard" concerns a hedge accounting issue in 2005, as to which the examiner referenced certain exchanges between KPMG's audit team and an internal KPMG specialist. (Compl. ¶ 517.) Plaintiffs allege that these exchanges are "particularly revealing" (*id.* ¶ 225), yet these exchanges fail to give rise to any inference (let alone a strong inference) that KPMG acted with scienter. To the contrary, plaintiffs' allegations make clear that a high level of attention was paid to the accounting issue under discussion. According to the examiner (as quoted by plaintiffs in the complaint), "in mid to late February, [the engagement partner] brought in KPMG's Department of Professional Practice ('DPP') to attempt to resolve the disagreement." (*Id.* ¶ 225.) He informed New Century's Audit Committee of the disagreement. (*Id.*) Thereafter, DPP gave "verbal approval" of the Company's hedge accounting. (*Id.*) When the specialist later re-raised the issue, the three most senior members of the engagement team (the engagement partner, concurring review partner, and manager) and the specialist had a "lengthy" conference call with "various members of DPP," after which a "high-ranking member of DPP" authorized issuance of KPMG's audit report. (*Id.*) It is also alleged that the disagreement was "not resolved completely"

1 until the following month, when the specialist was provided additional documentation,
 2 and he then concluded there was a “misstatement of several million dollars.” (*Id.* ¶¶
 3 225–26 (emphasis eliminated).) That this misstatement was identified after KPMG
 4 issued its audit report—and after KPMG had given careful attention to the issue—
 5 does not give rise to a strong inference that KPMG acted fraudulently. *See Worlds of*
 6 *Wonder*, 35 F.3d at 1426. In fact it demonstrates the opposite.

7 Moreover, there are two additional reasons there can be no inference of fraud
 8 here, both of which derive from findings of the examiner that plaintiffs misleadingly
 9 omit from their complaint. First, in the sentence of the examiner’s report that
 10 immediately follows the excerpt quoted in the complaint, the report states that the
 11 hedging error misstatement “ultimately was deemed *immaterial*.” (Ex. A at 18 n.681.)
 12 Second, as the examiner reported (but plaintiffs’ allegations omit), if the hedge
 13 accounting error was corrected in 2005, it “would have resulted in *additional pre-tax*
 14 *earnings for that year*.” (Ex. A at 15 n.540, 18 n.681 (emphasis added).) The
 15 decision not to make the hedge accounting adjustment thus *lowered* the Company’s
 16 2005 earnings, hardly demonstrating KPMG’s intent to participate in a fraud to
 17 *increase* the 2005 earnings. *See Davis v. SPSS, Inc.*, 385 F. Supp. 2d 697, 709 (N.D.
 18 Ill. 2005) (“It is difficult to understand how [an allegation that revenue was
 19 understated] supports plaintiff’s contention that [defendants] misstated the company’s
 20 financials in order to inflate the price of its stock. Understating its revenue certainly
 21 does not serve that purpose.”).

22 Plaintiffs’ only other scienter allegation purportedly showing “acquiescence”
 23 and “disregard” by KPMG’s 2005 audit team involves New Century’s residual
 24 interests valuations. Plaintiffs allege that the audit team “repeatedly disregarded
 25 concerns” from KPMG’s internal SFG specialist regarding the discount rates used by
 26 the Company. (*See* Compl. ¶ 518.) But plaintiffs’ own allegations make clear that the
 27 specialist regarded New Century’s discount rate as “at the low end of the range” – not
 28

outside the range. (*Id.* ¶ 232 (emphasis added).)⁸ Moreover, KPMG obtained “supporting documentation” from New Century before determining that the discount rates were reasonable. (*Id.*) Although plaintiffs also allege that KPMG knew the Company used models to calculate the residual interests that were “flawed and generated errors” (Compl. ¶ 525), the examiner indicated – and plaintiffs do not contend otherwise – that there was nothing fraudulent about the continued use of the allegedly flawed models (*see* Ex. A at 10 (“Whether because of inattention, cost concerns, inertia, or other reasons, the Company continued to use” the models.)) In any event, plaintiffs’ allegation that KPMG knew of the allegedly “flawed” models does not suggest that it acquiesced in the Company’s accounting violations, nor does it raise an inference of scienter. *See In re Van Wagoner Funds, Inc. Sec. Litig.*, 382 F. Supp. 2d 1173, 1186 (C.D. Cal. 2004) (an accountant’s access to documents containing accounting errors “does not strongly compel an inference of intentional or deliberately reckless conduct”); *In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp. 2d 1148, 1175 (C.D. Cal. 2007) (“mere access to contradictory information . . . is not enough to show deliberate recklessness”).

The alleged facts thus clearly demonstrate that KPMG’s 2005 audit team deliberated with and considered the judgments of KPMG’s internal specialists, which precludes any inference of scienter.⁹ (*See* Compl. ¶ 529); *see also Worlds of Wonder*,

⁸ Plaintiffs omit that the specialist considered the discount rate to be “at the low end of the *acceptable* range,” and misleadingly ignore that the specialist told the examiner that he “*never* ‘recommended’ that New Century increase its residual interest discount rates.” (Ex. A at 11 (emphases added).) They also omit to mention that the specialist did not become increasingly concerned about the discount rates until 2006, after the 2005 audit. (*Id.*)

⁹ In addition, plaintiffs’ allegations ignore the detailed disclosure regarding the Company’s residual interests valuation including precise disclosure of the discount rates New Century used in its valuation estimate, in its 2005 Form 10-K. (*See, e.g.*, Ex. C at 123, 192.) The Company’s disclosure undermines plaintiffs’ claim that KPMG participated in a fraud on New Century’s investors, and negates an inference

(Footnote continued)

35 F.3d at 1426 (claim that accountant’s “ultimate resolution of the accounting issues . . . was incorrect” was not sufficient to establish scienter); *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1241 (S.D.N.Y. 1992) (where accounting items “involved complex issues of accounting as to which reasonable accountants could reach different conclusions,” “[i]t follows that no finding of fraud or recklessness can rationally be made”).¹⁰

2. Plaintiffs’ allegation that KPMG failed to staff its 2005 audits with auditors of sufficient experience does not raise a strong inference of scienter

Plaintiffs next allege that a strong inference of scienter can be drawn from KPMG’s audit staffing; they incorporate in their allegations the examiner’s conclusory assertion that the 2005 audit team did not have “sufficient experience in the industry and the particular tasks to which they were assigned.” (Compl. ¶ 520.)

Notwithstanding the examiner’s opinion, his report demonstrates that the audit team’s engagement partner had decades of experience in public accounting; the concurring partner had experience with financial institutions and leasing companies; the manager had audit experience and had worked three years as assistant controller for a mortgage lending company; and the internal SFG specialist had been the KPMG

of scienter. *See Worlds of Wonder*, 35 F.3d at 1425 (“The detailed risk disclosure in the Debenture Prospectus negates an inference of scienter.”); *In re Remec Inc. Sec. Litig.*, 415 F. Supp. 2d 1106, 1116 (S.D. Cal. 2006) (rejecting securities fraud allegations that the defendant misstated declining gross profit margins where the defendant “made full disclosure of its declining gross profit margins . . . in its SEC filings and public statements”).

¹⁰ That residual interest valuations involved complex judgments is reflected in New Century’s own 2005 Form 10-K, wherein the Company identified residual interest valuations among its “critical” accounting policies which required “management to make particularly subjective or complex judgments about matters that are inherently uncertain and because the likelihood that materially different amounts would be recorded under different conditions or using different assumptions.” (Ex. C at 76.) As plaintiffs acknowledge in their complaint, KPMG identified the Company’s residual interest valuations as a critical accounting policy. (Compl. ¶ 231.)

engagement partner on the New Century account. (*See* Ex. A at 16–17.) Quibbling about these staffing decisions does not come close to establishing that the audit was “so deficient that the audit amounted to no audit at all.” *Worlds of Wonder*, 35 F.3d at 1426. Also, that junior auditors performed some of the audit work, as is the case in all audits, likewise does not give rise to a strong inference that KPMG engaged in deliberate recklessness or intentional misconduct. *See, e.g., Scottish Re Group Sec. Litig.*, 524 F. Supp. 2d 370, 397 (S.D.N.Y. 2007) (rejecting allegation that scienter could be inferred from the fact that auditors on the engagement were “very junior people . . . who were unable to perform effectively”).

3. KPMG’s alleged failures to conduct its 2005 audits in compliance with GAAS do not raise a strong inference of scienter

Plaintiffs’ remaining scienter allegations cite the examiner’s “identification” of a series of alleged GAAS violations, several of which concern minor issues. (*See* Compl. ¶¶ 523-527.) Federal courts have repeatedly held that allegations that an auditor violated GAAS are not sufficient to establish an inference of scienter under the PSLRA. *E.g., DSAM Global*, 288 F.3d at 380; *Worlds of Wonder*, 35 F.3d at 1426; *Reiger*, 117 F. Supp. 2d at 1010 (“violations of GAAP or GAAS, without more, may establish negligence but *can never establish scienter* under Rule 10b-5 and the [PSLRA]” (emphasis added)). Two of these alleged GAAS violations, concerning New Century’s hedge accounting and residual interests, are discussed *supra*, at 17–20; plaintiffs have alleged no facts sufficient to give rise to a strong inference of scienter regarding KPMG’s work in those areas. The remaining alleged violations identified by the examiner likewise in no way suggest that KPMG was deliberately reckless or engaged in intentional misconduct, and do not present a cogent theory that KPMG committed fraud.

a. Allowance for repurchase losses reserve

Plaintiffs allege, based on the examiner's assertions, that the Company's allowance for repurchase losses reserve was materially misstated in 2005. (Compl. ¶ 71.) Plaintiffs admit, however, that the allowance for repurchase losses reserve was identified by KPMG during its 2005 audit as a "critical accounting policy." (See *id.* ¶ 227.) In addition, the examiner acknowledged the extensive work performed by KPMG in this area. The examiner asserts that KPMG performed quarterly reviews; tested internal controls and concluded that a control deficiency identified in 2005 was "inconsequential"; and tested the Company's assumptions, including its 90-day look-back assumption. (Ex. A at 19, 21.) Rather than showing that KPMG's audit work "amounted to no audit at all," *Worlds of Wonder*, 35 F.3d at 1426, these assertions negate any inference of scienter.

Most directly opposing an inference of scienter, the examiner himself concluded that after "investigat[ing] to determine how these material errors came about . . . and whether there was any purposeful failure to calculate the repurchase reserve . . . correctly," "[t]he Examiner *found no persuasive evidence of such a motivation.*" (Ex. A at 7 (emphasis added).) Plaintiffs do not challenge the examiner's conclusion, and the only facts they otherwise assert in support of their allegations are claims by two anonymous witnesses that KPMG failed to raise an issue about the Company's repurchase claims backlog (Compl. ¶ 213), and that KPMG would have uncovered the errors "had KPMG complied with GAAS" (*id.* at ¶ 214). These types of conclusory allegations are so vague that they should be disregarded completely, but in any event do not imply that KPMG's work was deliberately reckless. The mere assertion that KPMG could have done more work in certain areas of the audit is insufficient to demonstrate scienter. See *In re FARO Techs. Sec. Litig.*, 534 F. Supp. 2d 1248, 1266 (M.D. Fla. 2007) (dismissing Section 10(b) claim against auditor where "[t]o the extent Plaintiff contends this audit was not sufficient and

1 should have been a complete physical inventory (which apparently would have
2 revealed the inventory issues), such is, at best, an allegation of negligence”).

3 Despite the examiner’s conclusion that there was no purposeful failure to
4 calculate the repurchase reserve correctly, plaintiffs allege that a junior auditor learned
5 information concerning New Century’s backlog of repurchase claims during 2005 but
6 “did nothing with it.” (Compl. ¶¶ 227, 523). However, the examiner, who reviewed
7 all of KPMG’s work in this area, concluded that there was a “lack of due professional
8 care” and also found that, although the repurchase claims backlog began to increase
9 during 2005, its “explosive growth” occurred *after* 2005, “between year-end 2005 and
10 September 30, 2006.” (See Ex. A at 8.) Moreover, the examiner estimated that the
11 backlog may have warranted an additional \$8.3 million in the reserve at December 31,
12 2005. (*Id.* at 222.) This is an amount that clearly would have been immaterial at year-
13 end 2005 in light of New Century’s reported net earnings of \$416 million (*see* Ex. C
14 at 169), especially given that, as the examiner concedes, the company had
15 appropriately determined not to correct an unrelated \$9.6 million error, due to hedge
16 accounting, that would have increased earnings for the 2005 year. (Ex. A at 15
17 n.540.) In the end, plaintiffs’ suggestion that KPMG in 2005 ignored critical
18 information about a backlog that did not face “explosive growth” until 2006 is the
19 type of “fraud by hindsight” allegation not permitted under the PSLRA. *See In re*
20 *Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084–85 (9th Cir. 2002) (“The purpose of
21 [the PSLRA’s] heightened pleading requirement [for scienter] was . . . to put an end to
22 the practice of pleading ‘fraud by hindsight.’”).

23 **b. Allowance for loan losses**

24 Plaintiffs excerpt significant portions of the examiner’s discussion of KPMG’s
25 alleged violations of GAAS concerning New Century’s 2005 allowance for loan
26 losses (“ALL”) (Compl. ¶ 526), but plaintiffs omit the examiner’s conclusion: that the
27 accounting error by New Century was that the Company *overreserved* for loan losses
28

1 in 2005, lowering the Company's earnings for that year. (Ex. A at 12.)¹¹ That the
 2 accounting allegedly violated GAAP in a way that *lowered* the Company's earnings
 3 does not raise an inference that KPMG intended fraudulently to *inflate* the Company's
 4 earnings. See *In re Bally Total Fitness Sec. Litig.*, 2006 WL 3714708, at *8 (N.D. Ill.
 5 July 12, 2006) (where "the revenue for some quarters was at times understated and
 6 losses for some quarters were at times overstated" the court will not infer scienter); *In*
 7 *re Interpool, Inc. Sec. Litig.*, 2005 WL 2000237, at *18 (D.N.J. Aug. 17, 2005)
 8 (restatement that resulted in decreases in income in some years "tends to negate an
 9 inference that Defendants acted with intent to perpetrate a fraud on investors").

10 c. Mortgage servicing rights

11 Plaintiffs allege that KPMG violated GAAS in its audit of New Century's
 12 valuation of its mortgage servicing rights ("MSRs"). (Compl. ¶ 526.) Plaintiffs,
 13 however, do not contest that, as reported by the examiner, KPMG properly concluded
 14 that the potential audit difference "for the valuation of New Century's MSRs for the
 15 year-ended 2005 was only \$698,217, which was below the income statement posting
 16 threshold." (See Ex. A at 13.) In other words, the adjustment was so small and so
 17 plainly immaterial that it required no further examination. Adjustments with this
 18 small of an impact on the financial statements do not create an inference of scienter.
 19 *PR Diamonds, Inc. v. Chandler*, 364 F.3d. 671, 686 (6th Cir. 2004) (allegations of
 20 small adjustments are not "in your face facts" that "cry out" scienter); *In re Hypercom*
 21 *Corp. Sec. Litig.*, 2006 WL 726791, at *4 (D. Ariz. Mar. 9, 2006) (fact that financial
 22
 23
 24

25 ¹¹ The examiner's conclusion evidently caused plaintiffs to abandon their position in
 26 their previous complaints, where they alleged that the allowance for loan losses
 27 reserve was materially *understated*. (See Consolidated Class Action Complaint ¶ 105;
 28 Amended Consolidated Class Action Complaint ¶ 102.)

adjustments were small “detract[s] from any inference that [the defendant] acted with scienter”).¹²

d. Goodwill impairment

Plaintiffs also allege that KPMG violated GAAS in its review of New Century’s goodwill impairment testing, but this allegation does not give rise to a strong inference of scienter. Plaintiffs omit the fact that the examiner did not even find a misstatement in his review of goodwill. The examiner concluded only that the Company’s year-ended 2005 assessment “relied upon unsupported cash flow projections and a questionable discount rate.” (Ex. A at 14.) Although the examiner questioned whether KPMG adequately tested these calculations (*id.* at 22), he did not find, nor do plaintiffs allege, that goodwill was materially misstated in 2005. Thus, plaintiffs’ allegation that calculations were not carefully tested, which is based only on the examiner’s assertion, does not present any evidence of scienter. *See DSAM Global*, 288 F.3d at 390 (9th Cir. 2002) (“mere allegations that an accountant . . . failed to closely review files or follow GAAP cannot raise a strong inference of scienter”); *In re Williams Sec. Litig.*, 496 F. Supp. 2d 1195, 1289 (N.D. Okla. 2007) (rejecting plaintiffs’ argument that “because only two sentences in the 17,000 pages of work pages mention the FAS 121 impairment analysis, E&Y’s year-end 200 [sic] audit amounted to ‘no audit at all’”). Likewise, the fact that neither plaintiffs nor the

¹² Plaintiffs also highlight KPMG’s review of the Company’s amortization calculation for its MSRs, alleging that KPMG was “aware” of the Company’s departure from GAAP and “never calculated the impact of that GAAP violation.” (Compl. ¶ 526.) Plaintiffs repeat the examiner’s finding that KPMG’s “failure to quantify their impact, reflect[ed] a lack of due professional care” (*id.* ¶ 233), but the examiner did not find—and plaintiffs do not allege—that any potential error in the calculation of amortization of the Company’s MSRs was material or that KPMG failed to consider whether any error could be material. *See Reiger*, 117 F. Supp. 2d at 1010 (GAAS violations on their own cannot establish scienter).

1 examiner contend that there was an error related to goodwill defeats any claim of
2 misrepresentation with respect to this issue.

3 **e. Internal controls**

4 Plaintiffs finally allege that KPMG in 2005 “engaged in an inappropriately less
5 rigorous internal control audit given the limited experience of the senior associate
6 primarily responsible for the review.” (Compl. ¶ 527.) They also allege that some of
7 the deficiencies that KPMG found in 2006 existed at the time of the 2005 audit. (*Id.*)
8 Even if true, plaintiffs’ allegations are plainly insufficient to raise an inference of
9 deliberately reckless or conscious misconduct. Plaintiffs do not even attempt to tie
10 their internal control allegations into their theory of scienter, nor could they.
11 Although plaintiffs allege that KPMG’s 2005 audit team identified a number of
12 control deficiencies (*id.*), they make no attempt to explain why KPMG in furtherance
13 of a fraud would report deficiencies in some years but not others. *See Reiger*, 117 F.
14 Supp. 2d at 1013 (rejecting inference of scienter where “Plaintiffs make no attempt to
15 explain why [the auditor] would deliberately ignore improperly recognized revenues,
16 and then, several months later, recommend a restatement of those revenues”).

17 Clearly, none of these alleged GAAS violations satisfies the Ninth Circuit’s
18 requirement that plaintiffs demonstrate strong circumstantial evidence of KPMG’s
19 deliberately reckless or conscious misconduct. *See Silicon Graphics*, 183 F.3d at 974.
20 This is especially so considering that scienter in a case against an auditor requires a
21 strong inference that the auditor’s work amounted to “*no audit at all*” or an “*egregious*
22 *refusal to see the obvious, or to investigate the doubtful.*” *DSAM Global*, 288 F.3d
23 385 (emphases added). Because plaintiffs have failed to allege particularized facts
24 that raise any inference of scienter—let alone a strong inference supported by a cogent
25 and compelling theory of fraud—Count Seven should be dismissed.

CONCLUSION

For the foregoing reasons, KPMG respectfully requests that the Court dismiss the complaint as to KPMG, without leave to amend.

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Respectfully submitted,

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